Audit's
MONTHLY NEWS ANALYSIS OF SECURITIES OF REAL ESTATE INVESTMENT TRUSTS

Realty Trust Review

For delivery Monday, August 16, 1971 VOL. II, No.9

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TRUST MERGERS AND ACQUISITIONS GO FORWARD DESPITE THE LAZARD FRERES CASE

The first major merger of trusts--as opposed to sale or merger of the advisory companies--is under negotiation and the outcome may provide insight into the course of future consolidation in the trust industry. The proposed transaction, still under negotiation, would fuse Security Mortgage Investors and Medical Mortgage Investors into a single trust which would in addition purchase some mortgage receivables from General Electric Credit Corp. While GE Credit's exact contribution hasn't been spelled out, it is believed it's contribution would be enough to give it a one-third interest in the combined enterprise.

One part of the transaction would involve exchange of each Medical Mortgage share for 1.75 shares of Security. Since Medical Mortgage now has 1,344,787 shares outstanding, MMI holders would receive 2,353,377 shares, slightly less than the 3,278,359 shares of Security currently outstanding. The attraction is creation of an enterprise which can obtain leveraging funds more easily. MMI is now into bank lines for $1.4 million but hasn't leveraged; Security has $7.8 million bank lines plus $10 million in convertible debentures. Both trusts have been hobbled in obtaining new funds, and the merger could be the answer. Sale of a management company does not figure prominently since Security presently has no management company and the three parties will form a new advisory company. Hence the Lazard Freres decision, which has caused a lot of head scratching, apparently wouldn't apply. And there's real doubt that it applies to trust advisory companies anyway (see p.7).

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Published twice monthly on the second and fourth Fridays *Subscription $84 annually* *Group rates on request*

NEW FEDERAL SURVEY BEGINS PROBING CONSTRUCTION LOAN MARKET

Statistics of the construction and land development lending market are now coming into focus from a major new survey instituted by the U.S. Housing and Urban Development Dept. The new survey has now produced detailed statistics on the construction lending activity of seven major groups of lenders for the first three months of this year. At present the survey does not include construction lending activity by either the mortgage banking companies or the real estate investment trusts, with HUD intending to include both groups as soon as survey procedures can be ironed out.

The survey at present covers these seven groups: commercial banks, mutual savings banks, savings and loan associations, life insurance companies, Federal credit agencies including the Federal National Mortgage Association, private non-insured pension plans, and state and local retirement funds. The data released to date show that the first three groups apparently account for perhaps 95% of the construction lending covered. The table below summarizes construction lending activity for the commercial banks, savings banks and savings and loan associations for the first quarter of 1971

CONSTRUCTION LENDING BY THREE MAJOR TYPES OF INSTITUTIONS, 1971
(Mil. $)
Monthly commitment volume

	----Construction loans only----				----Construction & perm. loans----			
	Com. banks	Sav.banks	S&Ls	Total*	Com.banks	Sav.banks	S&Ls	Total*
January	$1,107	$23	$100	$1,230	$ 98	$ 75	$358	$ 567
February	704	14	147	865	124	107	489	748
March	1,045	16	239	1,307	228	117	676	1,052
TOTALS	2,856	53	486	3,402	450	299	1,523	2,367
	Construction loans acquired				Land loans acquired			
January	1,223	58	459	1,748	52	7	56	121
February	1,720	56	556	2,341	66	3	45	124
March	1,257	76	792	2,145	72	11	66	160
TOTALS	4,200	190	1,807	6,234	190	21	167	405

Holdings outstanding at end of month

	Construction loans**				Construction loan commitments**			
January	NR	NR	NR	NR	$14,060	513	4,548	20,249
February	NR	NR	NR	NR	13,642	582	4,857	20,195
March	13,915	703	6,655	21,616	13,826	628	5,459	20,902

Source: HUD Releases 71-251, 71-315, 71-433. NR-Not reported. *Totals include data for Federal credit agencies, life insurance companies, private non-insured pension funds and state and local retirement funds, not shown separately in this summary. **Includes construction-only loans and construction and long-term combination loans.

While experience with these data is too young to make any broad generalizations, several comments and tentative conclusions can be drawn.

1. Banks and savings and loan associations dominate the segment of the construction lending market surveyed. Together they account for $20.57 billion, or slightly over 95% of the $21.6 billion of construction loans reported outstanding at the end of the first quarter of 1971. Construction loan holdings by other major lender groups not included in the table are minor relative to the total, with $191 million held by Federal credit agencies, including Federal National Mortgage Association, $137 million by life insurance companies, and $15 million by both private and government retirement funds.

2. The total construction lending market appears to be running at the annual rate of $28 to $36.7 billion during the first quarter of 1971. These ranges have been developed by applying two sets of assumptions to the early HUD data and are highly tentative, but they do appear to fall within the lower range of earlier estimates.

The lower estimate of $28.0 billion is developed in the following manner: the $21.6 billion outstanding construction loans on March 31 (a total including both construction-only and combination construction and permanent loans) are assumed to have an average life of one year and thus this total effectively represents an annual rate for these lenders. To this total are added an estimated $3.8 billion annual volume from REITs and about $2.5 billion for loans closed by mortgage companies for their own account. This latter group is estimated to close about $4.0 billion loans for the year but an estimated $1.5 billion likely represents closings in the name of real estate trusts, life insurance companies, mutual savings banks and other primary lenders.

The higher estimate is developed from the relation of the $6.23 billion construction loan acquisitions during the quarter to total private construction. The loan acquisitions amounted to 43% of the $14.45 billion private construction put in place during the quarter. Since this series is the statistical measure of the volume of materials and labor spent on construction work, it is reasonable to assume that construction loan disbursements also follow this series closely. During the first quarter of 1971, construction spending was at an annual rate of $70.7 billion; if the 43% relationship is valid, then construction lending by covered lenders was at a $30.4 billion annual rate. After adjustment of REIT and mortgage company lending of $6.3 billion net, the construction lending market appears to have been operating at $36.7 billion annual rate during the first quarter.

In total then, these two estimates are equal to a range from 39.5% to 52% of total private construction spending during this quarter.

3. Land lending appears to be smaller than originally estimated, perhaps no more than $3 to $5 billion annually instead of the $5 to $10 billion formerly estimated. Those earlier estimates were derived from savings and loan data from the 1960s. The reported totals in the new HUD survey are significantly lower and the decline does not appear to be due wholly to definitional differences. Perhaps a more accurate relationship would be that construction lenders will concentrate resources in construction lending when activity is high and in land loans when construction is low. At the end of March surveyed lenders held $3.28 billion of land loans, and since the monthly volume of land loan acquisitions is a much smaller part of this total than for construction loans, it is likely that the term of these loans is much longer than for construction loans.

Taken together, the construction and development loan market probably was in the range of $31.0 to $41.7 billion annual rate in the first quarter of 1971.

4. The extent of combination construction and permanent mortgage lending is higher than previously estimated. It was known that most savings and loan construction lending, principally for one-family houses, took this form, but the HUD survey indicates that mutual savings banks, life insurance companies and Federal credit agencies also make significant volumes of such loans. At the end of March 1971, $13.26 billion of the $20.9 billion construction loan commitments outstanding were construction-only loans; $4.26 billion were combination loans and $3.50 billion were loans reported by S&Ls as "in process," which can include either single-purpose or combination construction loans.

As HUD's new survey becomes more comprehensive, the monthly data will be published in the Federal Reserve Bulletin, The Journal of the Federal Home Loan Bank Board, and Housing and Urban Development Trends, published by HUD. While gross flows of commitments and fundings will surface for investor appraisal first, it may not be long before other basic data on delinquencies and foreclosures will be available.

The mortgage trusts appear to have been supplying about $3.8 billion of short-term funds to this market during the first quarter of 1971, or a market penetration of between 9.1% and 12.25%. Our estimates of trust short-term construction and land development lending emerge from a recently completed tally of assets of 113 real estate trusts operating during this period made in conjunction with closing of our forthcoming book, THE REAL ESTATE TRUSTS: AMERICA'S NEWEST BILLIONAIRES. The total of trusts is much larger than reported last fall owing to inclusion of trusts making initial offerings since then, of smaller equity trusts, and of three privately sponsored trusts.

The survey, using latest available balance sheets, shows that short-term mortgage trusts continue to dominate the industry, holding slightly over half the $6.1 billion assets now controlled by trusts. In addition, the long-term mortgage trusts hold $1.2 billion assets and since most members of this group have come public during the past year, an estimated $0.6 billion of their funds are still committed to the short-term sector. In addition, some of the intermediate-term and private trusts operate in this sector, although no estimate of their activity has been included in our totals. The results of our latest survey of trust holdings:

CAPITALIZATION OF REALTY TRUSTS, MID-1971
(Million $)

Trust category	No.	Assets	Equity	Convert.	Fixed debt	Capital#
Short-term mortgage						
Independent	10	$ 915.72	$ 332.79	$ 144.70	$418.92	$477.49
Mortgage banker	17	702.87	384.08	74.03	234.16	458.11
Commercial bank	14	1,079.48	564.47	71.13	434.46	635.59
Misc. financial	10	578.54	333.53	77.78	160.03	411.31
SUB TOTAL	51	$3,276.61	$1,614.87	$ 367.64	$247.57	$1,982.50
Equity	38	1,253.41	552.98	81.88	581.90	634.85
Mortgage-intermediate	3	237.85	170.28	19.33	39.30	189.61
Mortgage-long-term	18	1,188.43	707.24	353.31	108.33	1,060.55
Private	3	180.00	180.00	--	--	180.00
TOTALS	113	$6,136.30	$3,225.37	$ 822.16	$1,917.10	$4,047.51

#Sum of equity and convertible debentures.

Last fall, there were 53 major mortgage trusts (both long-term and short-term) operating and they had $2,732,000 of assets. This very large group has now grown to 72 operating trusts with $4,703,000 assets, a 72% gain in assets within nine months. A significant portion of this growth has been provided by new offerings and short-term borrowings, either from banks or the commercial paper market, by the trusts. This survey shows that all mortgage trusts now have $1.39 billion in fixed-term debt for $3.23 billion capital (equity plus convertibles), or a debt/capital ratio of 0.43-to-1.

But growth in assets is slowing, reflecting the highly competitive conditions early this year. *Continental Mortgage Investors* assets were up only 3.2% for the June quarter and *First Mortgage Investors* up 1.1% in its April quarter. Continental however reported $80 million commitments in June and First indicates that asset gains were continuing in its July quarter. There is no doubt however that the first six months of 1971 tested the mettle of the short-term trusts.

COMMERCIAL BANK TRUSTS RISING ON WINGS OF COMMERCIAL PAPER

The survey shows that the commercial bank-sponsored trusts are making the most aggressive use of commercial paper. Nearly half--11 of 23--of the trusts now issuing commercial paper are sponsored by commercial banks, and as a result this group now has nearly caught up with the independent trusts in leverage ratio. The bank trusts now have a 0.68-to-1 debt/capital funds ratio, second only to the 0.88-1 ratio for the independents in the short-term sector. The mortgage banker trusts are at 0.51-1 and the miscellaneous financial group at 0.39-1. Here is a tally of the commercial banking group, showing debt-to-capital funds ratios for each trust.

CAPITALIZATION OF COMMERCIAL BANK SPONSORED TRUSTS
(Million $)

Trust	Date	Assets	Equity	Convert.	Debt	Capital	Lever. Ratio
American Fletch.	Apr.	$ 17.11	$ 12.64	--	$ 4.35	$ 12.64	0.34
Barnett Mtg.	June	43.47	23.96	--	19.35C	23.96	0.81
Cameron-Brown	June	51.60	41.99	--	9.43	41.99	0.22
Chase Manhattan	May	E323.00	101.72	$59.50	160.00C	161.22	0.99
Citizens & South.	June	112.80	51.54	--	61.02C	51.54	1.18
Citinational Dev.	Mar.	15.05	11.19	--	3.80	11.19	0.34
Cont. Illinois	June	113.57	46.02	--	64.64C	46.02	1.40
First of Denver	June	37.52	27.90	--	9.47C	27.90	0.34
First Pennsyl.	Apr.	62.60	35.16	--	26.01C	35.16	0.74
Sutro Mtg. Inv.	June	48.99	29.84	11.63	6.36C	41.47	0.15
Tri-South Mtg.	June	41.34	26.04	--	14.90C	26.04	0.57
Unionamerica M&E	May	41.18	23.48	--	17.60C	23.48	0.75
Wachovia Realty	May	88.15	63.17	--	24.48C	63.17	0.39
Wells Fargo Mtg.	Mar.	83.11	69.83	--	13.02C	69.83	0.19
TOTALS		$1,079.48	$564.47	$71.13	$434.46	$635.59	0.68

E-Estimated from May 27 offering. C-Trust issues commercial paper.

The dynamic move of the bank-sponsored trusts into commercial paper shows clearly in this tally with 11 of the 14 trusts in the group already in this market. Moreover, loan origination capability has been strong against a backdrop of sharply higher competition for short-term loans.

We believe investors should concentrate in this current market setting on bank-affiliated trusts with only moderate leverage at present where even small increases in leverage can create very favorable earnings increases. Moreover, the generally rising short-term interest rate pattern should be beneficial. Statistically we like *Cameron-Brown* and *Sutro*, both sponsored by widely known mortgage banking firms with commercial bank affiliations. Sutro is included in this category even though the proposed merger of the advisory company, Ralph C. Sutro Co., into Crocker National Corp. cannot be consummated for another 60 days or so (the merger has not been completed as stated in RTR July 12). Reviews of these two trusts:

Cameron-Brown Investment Group is lineally descended from a commercial bank, First Union National Bancorp, from which it derives strong borrowing capability. First Union is a major Southeastern bank with offices in 68 North Carolina cities. More directly related to operations, however, is Cameron-Brown Company, a mortgage banker which is owned by the bank and in turn is the adviser to the trust. Cameron-Brown Co. is one of the larger mortgage bankers servicing over $900 million in loans, also operating in the Southeast. The trust thus has the dual parental benefit of entry to credit markets and significant loan generation capability combined with extensive real estate expertise.

The trust also has a somewhat different and interesting make-up. Although classified by us as a short-term trust, its goal is to have only 60% short term while it strives for 25% long term, 10% medium and 5% in equity. Having started operations in September, 1969, the trust is coming closer to these objectives. By February, 1971, 75% of assets were in construction loans, 14% in development loans and 8% in junior loans. Its short-term percentage will gradually go down as funds go heavier into long-term lending. As of June, 1971, the trust had commitments of $96 million of which $21.45 million will go into construction loans that will be later funded by the trust as permanent loans. These loans also carry various types of equity participations. Permanent loans are yielding over 9 5/8% before participations and consist mostly of apartment, shopping center and office properties. Flexibility is the objective in order to take advantage of currently attractive mortgage markets. Its holding of junior mortgages are up to 10% of the portfolio and the first land purchase leaseback was recently made.

Investment by property type is essentially conservative. At mid-year, 58% was in apartment houses and condominiums, 7% in shopping centers, 10% in land, 14% in stand-bys and only 7% in specials such as hospitals, nursing homes and warehouses. While covering 17 states, loans are concentrated in the home territory of the Southeast where the adviser operates. Also, since July, 1970, all loans have been originated by the adviser. This trust has learned of the risk in going outside its area for participations from its loans on Four Seasons' properties. Daylight is finally in sight here for the remaining $2,600,000 defaulted loans. These should be recovered within a year under a recent disposition agreement with the trustee. Principal and most interest should be recovered. Redeployment of the funds could add over $0.15 a share to earning power annually.

The liability side of the picture is the most dramatic aspect of the situation and portends significant earnings growth. On June 30, the trust had $9,425,000 in short-term debt (bank lines) on its equity base of $41,989,000. With large commitments coming due, the portfolio will greatly increase and make commercial paper sale feasible. The mechanics are currently being arranged. This leverage play will add to already solid earnings. Second quarter profits were $0.67 ($0.51 diluted for warrant conversion under APB 15) compared with $0.66 in the first quarter. During this period, the trust was rolling over its old portfolio and

yields declined while it was not leveraged. Yields on the existing portfolio will continue down from 53% yielding over 12% in the third quarter to 47% in the fourth quarter, 17% in the first quarter of 1972, and 14% in the second 1972 quarter. This should be much more than offset by low-cost commercial paper leveraging.

The stock at 29½ sells at 11.4 times the recent quarter's annualized earnings (before dilution). This is quite reasonable considering the trust's bright prospects for the next year at least. Longer term, this is not an excessively cheap multiple considering potential dilution from current market from warrants equal to 100% of shares outstanding exercisable at $25.

Earnings of *Sutro Mortgage Investment Trust* appear poised to make a dramatic breakout from a long period of modest growth. The stage has been set for this growth by a series of recent events which include:

1. Sale of $15 million convertible debentures April 22, 1971 vaulted the trust well upward in the ranks of larger bank trusts. Moreover, the conversion price of $20 was a healthy 36.4% premium over the pre-offering book value of $14.66 per share and will boost book value by over $2 to $16.69 upon full conversion. The debentures carry a 6 3/4% interest rate and also had 300,000 warrants attached. The warrants are exercisable at $20 per share through April 15, 1974 and $22 thereafter till April 1976. Trust capital has now expanded to $41.47 million as a result of the offering.

2. The trust's adviser, Ralph C. Sutro Co., has agreed to be acquired by Crocker National Corp., holding company for the Crocker-Citizens National Bank which has $6.2 billion assets and 282 offices throughout California. Necessary regulatory approvals are expected to be completed in the next 60 days or so and should permit fuller utilization of the bank sponsorship relationship. Ralph C. Sutro Co. is one of the nation's oldest and largest mortgage banking companies, with over $577 million in mortgage loan servicing. Even prior to the affiliation, the trust has issued modest amounts of commercial paper and should be able to increase this over coming quarters. The current leverage ratio of 0.15-1 is among the lowest for trusts associated with banks. Bank lines of $20 million are adequate and the trust relies basically upon bank borrowings since escrow accounts can be used as compensating balances.

Although some concern has been expressed that recent court decisions regarding sale of mutual fund management companies could be applied to this sale, attorneys are not at all convinced that the rules relating to fiduciary offices for mutual funds also apply to REIT advisory companies. Mutual fund managers by law are required to seek approval from fund shareholders for any transfer of ownership, while trust advisers are not under the same limitations. Moreover, the case causing the most concern stems from Lazard Freres' sale of management rights for a mutual fund and a court ruling that Lazard Freres was liable to the fund for profits on the sale. But REIT attorneys point out that a REIT adviser operates under rules generally giving trustees the right of termination of a contract within 60 days. In addition, the acquisition agreement with Crocker does not mention the trust advisory agreement, further widening the factual gap between the two situations.

3. Portfolio has been expanded and yield upgraded, while a higher level of commitment volume augurs well for solid portfolio growth near-term. For the past year Sutro's portfolio has remained in the $36-$38 million range while commitment volume steadily built from $15 to $43.5 million. This permitted the trust to fully invest proceeds from the April offering quickly, with the result that total portfolio grew by 21% from $38.7 to $46.9 million in the June quarter. The long-term sector,

which had been yielding 7.7%, has been reduced to $3.5 million and the funds invested in higher yielding short-term loans at about 10.67%. Overall portfolio yield appears headed moderately higher in the balance of 1971 and into 1972. We are estimating growth to about $60 million by next March, end of SMIT's fiscal year, but portfolio could be as high as $70 million by then.

This portfolio growth coupled with low-cost bank lines and commercial paper capabilities should permit earnings to grow to about $0.48/sh. fully diluted in the March 1972 quarter, vs. $0.40 in the June quarter. SMIT shares at 19 3/8 (ASE) are priced at about 12 times earnings currently. The higher earnings we see should command a market price of about $23-$24, and the market possibly could give a slightly higher valuation based upon the trust's execution of a well-conceived growth plan. The shares are a buy for conservative-to-moderately aggressive accounts.

In view of the bright prospects for these two issues, we are purchasing 200 shares of Cameron-Brown ($5,968 with commissions) and 300 shares of Sutro ($5,893 with commissions) to our Model II portfolio. In addition, Continental Illinois Realty shares have reacted reflecting concern over the Lazard Freres decision. This concern appears unfounded and we use the dip to buy 100 more shares ($3,374 total). Purchases will be made with accumulated dividends plus proceeds ($7,928 net) from sale of our *Diversified Mortgage* holding. We leave DMG with great reluctance because the trust appears to be near realizing the gains we foresaw earlier. But these gains are now made relatively less attractive by internal developments in the issues added.

PORTFOLIO I
LONG TERM, INFLATION PROTECTION

Sh.	Issue-Ann. Div.	Orig. price	Mkt. 8/10	Mkt. Val.
800	Gen.Growth -0.80	$23.13	23.50	18,800
400	US Lsg. RE -1.08	22.13	19.25X	7,700
700	Penn. REIT -0.85	12.50	12.50X	8,750
750	Rlty.Inc.Tr-1.20	17.13	15.38	11,535
600	Saul(B.F.) -1.24	19.75	18.88X	11,328
400	Wash. REIT -0.96	12.63	10.63	4,252
600	GREIT Rlty -1.60	18.25	17.13X	10,278
200	BankAm.Rlt.-2.20	28.75	24.13X	4,826
700	Mob.Hm.Com.-0.47	9.75	7.88	5,516
300	Cabot C&F---New	22.00	21.63	6,489
	Mkt. value	$97,355*		$89,474

*Including transaction costs

Cash, begginning of mo.	$ 3,622
Dividends received	992
New purchases-none	--
Cash, end of month	$ 4,615
Net asset value	$94,088
Net change in month	- 422
% change	-0.4

PORTFOLIO II
INTERMEDIATE TERM, AGGRESSIVE

Sh.	Issue-Ann. Div.	Orig price	Mkt. 8/10	Mkt. Val.
700	Alison Mtg.-2.16	$21.00	23.00	16,100
400	Assoc.Mtg. -2.40	29.38	24.13X	9,652
300	Cont. Ill. -2.48	32.12	33.38X	10,014
450	Larwin MI -2.08	24.15	27.13	12,209
300	Diver. Mtg.-2.04	29.13	26.75X	(8,025)
200	Guard. MI -3.04	33.50	35.75X	7,150
300	Grt.Amer.M -1.98	26.63	27.75X	8,325
200	First Mtg. -2.24	32.38	27.50	5,500
200	No.Amer.M -2.20	28.00	27.38	5,476
100	Am.Cent. -2.32	26.00	24.38	2,438
400	Fidelity M -2.00	20.00	20.88	8,352
		$94,240*		
200	Cameron-Br.-2.44	29.50	29.50	5,900
300	Sutro Mtg. -1.60	19.38	19.38	5,814
100	Cont. Ill. -2.48	33.38	33.38	3,338
				$100,268

Cash beginning of month	$ 7,515
Dividends received	903
Proceeds from sale-Div.Mtg.	7,928
New purchases, net	15,235
Cash, end of month	1,111
Net asset value,end of mo.	$101,379
Net change in month	+ 4,350
% change	+ 4.5

Written as of noon Thursday August 12.